

## **F. CORPORATE PRACTICE OF MEDICINE**

by

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### **1. Introduction**

Some states--California, Texas, Ohio, Colorado, Iowa, Illinois, New York and New Jersey--preclude hospitals from employing physicians to provide out-patient services. These states legislate what is known as the corporate practice of medicine doctrine. The rationale for prohibiting employment of physicians by hospitals is derived from the concept that individual physicians should be licensed to practice medicine not corporations. See *Painless Parker v. Board of Dental Examiners*, 216 Cal. 285, 14 P.2d 67 (1932). The basic premise is the divided loyalty and impaired confidence between the interests of a corporation and the needs of a patient. In practice, states with corporate practice of medicine laws permit formation and licensure of business corporations established as professional service corporations (but not a non-profit corporation) to practice medicine but only if controlled by physicians. See *State Prohibition on Hospitals Employment of Physicians*, "Department of Health and Human Services, Office of Inspector General," Document No. OEI-01-91-00770 (November, 1991).

The problem for a tax exempt hospital that wants to operate a wholly-owned, out-patient clinic in a state with corporate practice of medicine laws is the clinic can't incorporate under the state's non-profit laws. Because professional service corporations are intended to operate as business enterprises, recognition of IRC 501(3) exemption requires a considerable number of safeguards to ensure charitable organization and operations. This article discusses exemption considerations where a hospital establishes an entity to provide out-patient physician services in states with corporate practice of medicine laws. It also provides samples of exemption determinations issued in each such state.

### **2. What do Corporate Practice of Medicine Laws Require?**

The corporate practice of medicine laws require corporations created to employ physicians in an outpatient clinic to be incorporated under the state's professional service corporate laws. The laws also require all providers of medical services to be licensed. Often, the laws mandate that all stock in the corporation providing the services be held by a physician licensed in the state and all members of the board of directors be physicians licensed by the state. Generally, one physician holds all the stock, but New York state law indicates all physicians employed by the professional service corporation may be shareholders.

3. How is the Professional Service Corporation Established to Obtain Exemption?

A professional service corporation issues all of its stock to a physician shareholder who normally becomes the corporate director. A physician shareholder is a licensed physician who is generally employed on the administrative staff of an IRC 501(c)(3) hospital (or a tax-exempt entity within the affiliated hospital system) which acts like a parent of the professional corporation. The physician shareholder may also be an employee of the professional service corporation. The physician shareholder, the professional service corporation (hereafter Professional Corporation) and the IRC 501(c)(3) hospital (hereafter the Parent) enter into a contractual arrangement--a shareholder control agreement--whereby all structural and financial control over the Professional Corporation is transferred to the Parent. Under the shareholder control agreement, the physician shareholder becomes a controlled physician shareholder by agreeing to hold the stock for the benefit of the Parent. This type of legal arrangement is often referred to as a "captive professional corporation."

In addition to the shareholder control agreement, control is exercised by the Parent over the director(s), the controlled, physician shareholder and the Professional Corporation through the following types of documents: by-laws, articles of incorporation, employment agreement (between the controlled, physician shareholder and the Parent), trust agreement (replaces a shareholder control agreement), and a management agreement with an affiliated entity (in certain circumstances this is used by the Parent to assure further day-to-day control).

The Service requires the Parent to provide a written representation that it will exercise all of its rights in law and equity to prevent diversion or wasting of the Professional Corporation's charitable assets. This is done as an additional safeguard to any actions the state may take since the state's authority to enforce charity on a Professional Corporation is not entirely clear.

IRC 501(c)(3) status for the Professional Corporation is based on derivative exemption through an integral part analysis. The Professional Corporation is treated as performing an essential function that furthers an exclusively exempt purpose of the Parent that controls it. See Rev. Rul. 78-41, 1978-1 C.B. 148.

4. Problems Created by Corporate Practice of Medicine Laws

A. Legal Verses Beneficial Ownership of Stock

The Service is interested in receiving assurances, such as an opinion from the state attorney general, that legal ownership of the stock of a captive Professional Corporation, not beneficial ownership, is sufficient to comply with the requirements of the state laws. This gives the Service certainty that beneficial ownership of the Professional Corporation

can be held by a non-physician. In all states where the Service has issued determinations, the Service has received this information.

B. Articles of Incorporation

To be exempt under IRC 501(c)(3), an organization must be organized and operated exclusively for exempt purposes. In this regard, it must satisfy the organizational and operational tests set forth in Regs. 1.501(c)(3)-1(a). The organizational test requires that "organizational language" be included in an organization's articles of incorporation limiting its purposes to one or more exempt purposes, not expressly empowering it to engage in activities which are not in furtherance of one or more exempt purposes (other than as an insubstantial part of its activities), ensuring that its assets are dedicated to one or more exempt purposes on dissolution, etc. Often, this language when read in conjunction with the laws created to govern a Professional Corporation formed under a state's business corporation laws appears to be inconsistent. Thus, the Service is interested in receiving assurance that the organizational language is not contrary or incompatible with the language or intent of the statute(s) creating the Professional Corporation. In all states where the Service has issued determinations, the Service has received this information.

C. Does the State Attorney General Safeguard IRC 501(c)(3) Professional Corporations?

As previously noted, the Service requires the incorporating IRC 501(c)(3) entity, generally, the Parent, to make written representations it will exercise all of its rights in law and equity, which, like the attorney general, would prevent diversion or wasting of a charitable asset of the Professional Corporation.

D. All Stock of Corporation Held by Physicians

Key documents of the Professional Corporation such as articles of incorporation, by-laws, shareholder control agreements, employment agreements, and trust agreements should provide that all the rights in the stock held by the physician shareholder are transferred to the Parent.

This is a problem area because often these documents are not created with an exempt organization in mind. Frequently, in the four corners of these documents, structural and financial control still remains with the physician, the shareholder, or the director which is inconsistent with exemption. Strict attention to all sections of these documents is paramount to ensure the Parent is in control.

E. No Bifurcation of Control

Unlike a non-profit corporation, a Professional Corporation is controlled by its shareholder(s) in addition to its board of directors. Therefore, articles of incorporation and by-laws have to be closely examined to determine that no powers adverse to charity are still held by the physician shareholder(s).

F. No Community Board of Directors

In many corporate practice of medicine states, the Professional Corporation's board of directors must be comprised of licensed physicians. This is inconsistent with the community board concept which is integral to the charitable promotion of health. See the FY 1997 CPE article, Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy.

To solve this problem, the IRC 501(c)(3) Parent should elect or appoint physician board members who have no financial interest in the Professional Corporation. Further, the Professional Corporation's by-laws should provide the Parent has the following powers:

1. the right to amend, alter, or repeal the certificate of incorporation and by-laws.
2. the right to approve significant actions including (i) the annual operating and capital budgets and material deviations from such budgets, (ii) the sale, lease, mortgage or other transfer or encumbrance of real or certain valuable personal property, (iii) the merger, acquisition, consolidation, liquidation, or dissolution, (iv) the right to elect directors, appoint directors, establish or change the number of directors, as well as remove directors at any time with or without cause, (v) the settlements of claims and litigation, and (vi) the selection of auditors.

In some states, licensing laws prevent the Parent from electing or appointing the board. However, the Professional Corporation's board can be controlled in other ways. Either the shareholder control agreement or the employment agreement is used to control the physician-director's actions. These agreements provide that the physician director is required on any matter submitted for a vote to the director to vote only as approved in advance and in writing by the Parent.

G. Non-Profit? That is the Question

To accommodate charity, the Service has been willing to recognize exemption of Professional Corporations only in states with active corporate practice of medicine laws. Therefore, applicants seeking exemption that are formed in states without corporate practice of medicine laws should be formed under the state's non-profit corporate laws.

5. Requirements for IRC 501(c)(3) Exemption

The following information is generally required in articles of incorporation, by-laws, shareholder control agreements, and employment agreements. The placement of this information may vary from applicant to applicant. For example, some applicants use employment and management agreements instead of shareholder control agreements to bond the physician shareholder to the Parent. The important point is, whatever contractual device is used; the Parent obtains complete power to ensure that the Professional Corporation's activities always accomplish charitable purposes.

A. Shareholder Control Agreement

Generally, the Professional Corporation, the Parent, and the physician shareholder enter into a shareholder control agreement. A shareholder control agreement is a legally binding contract which regulates the actions of a holder of stock to the terms of the agreement. Under the shareholder control agreement, the physician shareholder agrees to hold and vote the stock for the benefit of the Parent. The shareholder control agreement should:

1. Recite the organizational language of IRC 501(c)(3) and impose those provisions on the operation of the Professional Corporation.
2. Recite that the physician shareholder and directors (when there is no community board) must vote each and every share of the corporation's stock only as approved in advance and in writing by the Parent.
3. Recite that the Parent has the power over the controlled physician shareholder to initiate any and all actions regarding the election and removal of the corporation's board of directors.
4. Recite that if the controlled physician shareholder's employment with the Parent is terminated for any reason, the Parent shall have the power to designate the person to whom the stock will be transferred. This is done in order to enable the Parent to appoint another of its physician employees as the owner of the corporation's stock. In conjunction with this requirement, the Parent may require the physician shareholder on the date of signing the

shareholder control agreement or employment agreement to tender all the stock endorsed in blank for transfer to the Parent to be held in escrow until the end of the shareholder's term.

5. Provide that the physician shareholder must give the Parent written notice of intent to dispose of the corporation's shares and such notice shall be deemed to be a binding offer to sell such shares to a designee of the Parent.
6. Provide that each share of stock be affixed with a legend stating it is subject to the shareholder control agreement.
7. Recite that the shareholder physician shall not transfer, encumber, or otherwise dispose of (by sale, pledge, gift, devise, or other disposition) any shares of the stock now or hereafter held of record or beneficially owned by the shareholder physician except as approved by the Parent.
8. Recite that the Professional Corporation's stock is limited to a nominal value of \$1.00 per share.

B. Board of Directors

1. If allowed under state law, all of the corporation's directors should be appointed by the Parent. Thus, the Parent's community board exercises full control over the activities of the Professional Corporation. If this is included in the shareholder control agreement, it may not be needed in the by-laws.

C. By-laws

1. If allowed under state law, the by-laws should provide all of the directors are appointed or elected by the community board of the Parent and the directors can be removed with or without cause.
2. The by-laws should prohibit any appreciation received by the shareholder upon the disposition of the stock.
3. The four corners of the by-laws should be thoroughly reviewed to determine if the physician shareholder has any remaining powers which are inconsistent with IRC 501(c)(3) status.

D. Articles of Incorporation

1. The Professional Corporation's articles of incorporation should include the organizational language of IRC 501(c)(3) and state it is operated to further the charitable purposes of the Parent, an IRC 501(c)(3) organization.
2. The articles should provide for a waiver of preemptive rights, which read as follows:

No holder of any share of any class of capital stock of the corporation shall be entitled, by preemptive or other right, to subscribe for or otherwise to purchase any share of any class of capital stock which the corporation may issue. No share of any class of capital stock of the corporation shall be subject to any such preemptive or similar right.

E. Physician Employment Agreements

Because this is a Professional Corporation, it is important for the employed physicians to understand the corporation's charitable goals. The individual physician's employment agreement should contain the following provisions:

1. The agreement states the corporation is formed by the Parent to further its IRC 501(c)(3) charitable purposes.
2. The agreement recites that all services to patients are provided on a nondiscriminatory basis as detailed in a separate charity care policy of the corporation.

F. Physician Compensation

1. The administrative file should contain information indicating who determines and approves physician compensation. It should also state if any physician employees and/or independent physicians who contract with the Professional Corporation are on the body which approves physician compensation.
2. The administrative file should contain information stating that for each physician employee and/or physician independent contractor, total compensation (base, benefit and bonus) is reasonable for the geographic locale and physician specialty. Where physicians receive incentive compensation or compensation based on revenues, the Service is concerned that such compensation programs could, if various charitable safeguards are not present, result in possible unreasonable, total compensation. Therefore, the administrative file should contain representative employment contracts (with names deleted) for each different way an incentive is calculated.

3. See this years CPE article Physician Incentive Compensation for a discussion of physician compensation.

G. Conflicts of Interest Policy

The Professional Corporation's by-laws should contain a substantial conflicts of interest policy such as the updated example contained in this years CPE article Revised Conflicts of Interest Policy.

H. Charity

The Professional Corporation should demonstrate it promotes health in a way that benefits the community through, for example, a separate charity care policy in its corporate name. The Parent's charity care policy is not enough.

I. Hospital Representations

To reduce the likelihood of private benefit through physician ownership, the Service requests the Parent to make the following written representations during the application process:

1. The Parent's shareholder control agreement with the designated physician shareholder is enforceable at law and in equity.
2. The Parent will not suffer or permit the physician shareholder (together with all successors, heirs and assigns of the physician shareholder and all subsequent designees holding the corporation's stock) to financially benefit in any manner, directly or indirectly, from the physician shareholder's legal ownership of the stock of the corporation as the designee and fiduciary of the Parent.
3. The Parent will expeditiously and vigorously enforce all its rights in the shareholder control agreement and will pursue all legal and equitable remedies to protect its interest in the assets and stock of the corporation.



6. Conclusion

When the Service reviews IRC 501(c)(3) applications for Professional Corporations, it must be careful to determine from all documents submitted that charitable safeguards are in place. Because each state's requirements under the corporate practice of medicine laws differ in subtle ways, the Service must work with the applicants to ensure the necessary language is included and is enforceable so that, in the end, structural and financial control shifts to the Parent.

To aid in determining Service application processing requirements in states with corporate practice of medicine laws, this article includes exhibits of the relevant portions of those favorable determinations.

**EXHIBIT    A**











**EXHIBIT B**









**EXHIBIT C**

















**EXHIBIT D**





















**EXHIBITE**













**EXHIBIT F**













